FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Basel Committee on Banking Supervision

OUR REFERENCE	YOUR REFERENCE		DATE
13/7363			28.06.2013

Response to The Basel Committee on Banking Supervision consultation document Supervisory framework for measuring and controlling large exposures

The Financial Supervisory Authority of Norway (Finanstilsynet) welcomes this initiative of the Committee to introduce a new supervisory framework for measuring and controlling large exposure.

The financial crisis and its aftermath have shown that the risk related to concentrated exposures to individual counterparties needs to be properly addressed. The large exposures regime is an important backstop regime that limits the impact on an institution of a counterparty failing. Finanstilsynet believes market failures arising as a result of large single name exposures that give rise to the risk of traumatic losses due to “unforeseen events” and that this market failure is not (fully) addressed by any of Basel II’s three pillars. Finanstilsynet considers that a limits-based “back-stop” regime is the most appropriate regulatory tool. Finanstilsynet therefore welcome the initiative to introduce a revised supervisory framework for measuring and controlling large exposures.

The current regulation on large exposure has been implemented by implementing the EU directives on capital requirements (CRD). Guidelines on the implementation of the revised large exposures regime issued by The European Banking Authority (EBA) is also used by Finanstilsynet as a supplement to the regulation, especially in defining of groups of “connected clients”, in particular with reference to the concepts of “control” and “economic interconnection".

The proposal on regulation of large exposure made by the Basel committee is applicable for larger cross boarder banks. However, the regulation will also be implemented in many countries were the regulation also will apply for smaller domestic banks. In our comments we have therefore also commented on the effect for these banks

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Comments on specific questions

Definition of a large exposure

Q1: The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting.

On page 5 of the consultative document it says *"The purpose of monitoring large exposures is to raise early warning flags that may then warrant further investigation by supervisors. For these flags to be effective, monitoring limits need to be well below the large exposure limit"*. Finanstilsynet supports this, but does not find convincing arguments that a distance between the definition of a large exposure and the large exposure limit of 15 percentage points is too low. However, Finanstilsynet supports the idea of improving the framework on how banks should measure and aggregate their exposures to a single counterparty and which factors they should take into account when considering whether separate legal entities form a group of connected counterparties.

Finanstilsynet does not have data/information to assess the exact impact of lowering the definition of a large exposure from 10 to 5 per cent. Hence, the assessment is based on best-effort basis.

In Norway we have a few large banks and several small savings banks. As of end-2012 an exposure greater than 30 million EUR would, on average, be defined as a large exposure for Norwegian banks given the threshold of 10 per cent of total regulatory capital. However, if we look at the median an exposure only has to be greater than 4 million EUR to be defined as a large exposure. Hence, if the threshold was lowered from 10 to 5 per cent at end-2012, 50 per cent of the Norwegian banks would have had to report all exposures greater than 2 million EUR to the authorities. As of end-2012, 126 Norwegian banks reported 736 large exposures to a total of 1723 individual counterparties. In addition comes the reporting of investment firms, mortgage companies, finance companies and holding companies.

Finanstilsynet also collects data from the 18 largest banks on all exposures higher than or equal to NOK 500.000[1] to non-financial domestic corporations. These figures indicate that the largest banks would have to report almost 4 times as many exposures if the definition of a large exposure is reduced from 10 to 5 per cent. Finanstilsynet has reasons to believe that this figure will be even higher for the small and medium sized Norwegian banks.

Based on what is mentioned above Finanstilsynet suggest that the proposed definition of large exposures and the proposal for reporting should be further assessed.

Definition of connected counterparties

2. The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

Finanstilsynet generally supports the proposal to combine rules-based approach and guidance based approach, especially for identification of connected counterparties based on control and

[1] 68.111 EUR as of 31.12.2013

economic dependence. However we have some remarks based on our experience from the use of EBA guidelines for identification of connected counterparties.

The Committee suggests that banks should actively seek to identify possible connected counterparties where the combined exposure to a set of counterparties is likely to reach the large exposure definition once connected. While for assessing connections between counterparties based on control no specific constraints is mentioned. This differs from EBA guidelines were a proportionate approach is used so that as a minimum, an intensive process should be applied to all exposures that exceed 2% of an institution's own funds at a solo or consolidated level. Finanstilsynet suggest that the Committee considers a similar proportionate approach and that the level that is set should be determined after an impact study is carried out.

If there are two partners/owners that hold 50:50 participations in a company and that this responsibility is performed jointly, we are of the opinion that they should be considered as connected counterparties. We therefore think that point 31 should be should be rephrased the following way:
"To assess connectedness through control, the Committee proposes that criterion (a) is met automatically if one entity owns ~~more than~~ 50% or more of the voting rights of another entity."

For connectedness based on economic independence the minimum criteria in the consultative document is largely concurrent with EBA guidelines. EBA guidelines provide more examples of economical connectedness than the consultative document, but several of them can be interpreted to be comprised by the third bullet point in point 34 in the consultative document. However there are some examples that we think should be included in the Committees minimum requirements so that the requirements are more in line with the guidelines from EBA.

For connectedness based on economic interdependence it should be stated that it is not possible to give a comprehensive list of possible cases of economic interconnection. Furthermore that it should be stated that each case will have its own characteristics, and the identification of interconnected clients requires thorough knowledge of the customer/client and not least a consciousness of connected risks among the institution's staff.

Capital measure – definition of eligible capital

3. The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.

Finanstilsynet believe that the large exposure limit should be based on Common Equity Tier 1 capital. Retained earnings and other Common Equity Tier 1 capital is the capital that is sure to absorb losses on a going concern basis. Although Additional Tier 1 capital will be more loss-absorbing through the rules that will enter into force with Basel III, it is only Common Equity Tier 1 capital that can absorb losses in a straightforward manner without the bank approaching the point of non- viability.

The current limit of 25 per cent of own funds is high. We believe the best way to tighten the rules is through stricter requirements for the type of capital that the limit shall be based on. In this way, smaller institutions with little own funds will be able to maintain a high limit by adjusting the capital structure with a higher proportion of Common Equity Tier 1 capital. Such a change in the capital structure will also be in line with the new Basel III requirements.

Some banks have significant amounts of additional Tier 1 capital and Tier 2 capital and have large exposures close to the current limit. Hence, we agree that the new limits should only be fully implemented from 1 January 2019 to allow the institutions sufficient time to adapt.

Quantitative information on the effect of basing the limit on either Common Equity Tier 1 or Tier 1 capital for Norwegian institutions is included in Annex 1. As shown in the tables of Annex 1, the number of breaches of the limit increases quite a lot if the limit is based on Common Equity Tier 1 capital instead of Tier 1 capital. However, most breaches are minor and account for a small proportion of average profits. We therefore see no particular problem with basing the limit on Common Equity Tier 1 capital, provided that the institutions have adequate time to adapt to the new rules.

Exposure measure – definition of exposure

4. The Committee welcomes views on the extent and nature of the use of internal models (when they have received supervisory approval for being used for Pillar 1 capital requirements purposes) to measure large exposures.

Finanstilsynet fully support the Committee's view that model risk should have no bearing on exposure values in the large exposure framework. This is in line with the current large exposure regulation in Norway were the use of internal models for large exposure purposes is not allowed. The framework serves as a backstop to limit maximum, possible loss and should as such be a robust measure. Internal models are based on many assumptions and may produce undesirable differences between institutions and countries. It will also introduce a lot of complexity in the rules that are unnecessary for the design of absolute limits.

We believe banks' risk models have clear limitations especially during major shifts in economic outlook. After long periods of economic upturn, there is a risk that the capital requirements and risk factors for exposures calculated by internal models could be too low. The reason for this is that it is difficult to predict in advance when a recession will occur and how it will develop, and adequately address the need for increased capital.

In addition, large exposures will have more idiosyncratic risk compared with a number of smaller exposures that add up to the same amount, making internal models less appropriate. We thus believe that to serve as a simple backstop measure to limit the possible maximum loss on large exposures, conservative standard risk weights should be used.

Interbank exposures

11. The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

Finanstilsynet supports the proposal to apply the large exposure limit to interbank exposures in the same way that it is applied to any other exposures to third parties. However, as the Committee also mentions, there are instances where exemptions would be warranted.

Occasionally smaller banks have large exposures toward larger banks, which are used as settlement banks. The possibility of higher limits for institution exposures is taken into account in the current EU-legislation, as exposures to third party institutions shall not exceed 25 % of the institution's eligible capital *or* EUR 150 million. Though, the limit shall not exceed 100 % of the institution's eligible capital. Finanstilsynet believes the Basel regulation should contain a similar feature which is of importance to smaller banks.

On behalf of Finanstilsynet.

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Annex 1

	Number of exposures exceeding the limit		
	Own Funds	Tier 1	Common equity tier 1
Large banks and medium sized banks (total assets > NOK 10 billion)	0 (0.0 %)	1 (0.5 %)	4 (1.9 %)
Small banks (total assets < NOK 10 billion)	1 (0.2 %)	11 (2.1 %)	25 (4.7 %)
Banks (total)	1 (0.1 %)	12 (1.6 %)	29 (4.0 %)

Table 1: Number of exposure exceeding large exposure limit. Percentage of total exposures in parenthesis

	Number of banks exceeding the limit		
	Own Funds	Tier 1	Common equity tier 1
Large banks and medium sized banks (total assets > NOK 10 billion)	0 (0.0 %)	1 (3.6 %)	4 (14.3 %)
Small banks (total assets < NOK 10 billion)	1 (1.0 %)	2 (2.0 %)	11 (11.2 %)
Banks (total)	1 (0.8 %)	3 (2.4 %)	15 (11.9%)

Table 2: Number of banks exceeding large exposure limit. Percentage of total number of banks in parenthesis